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UNCLAS SECTION 01 OF 02 SAO PAULO 000548

SIPDIS
SENSITIVE

STATE PASS USTR FOR KDUCKWORTH
STATE PASS NSC FOR GTOMASULO
STATE PASS EXIMBANK
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE
DEPT OF TREASURY FOR JHOEK, BONEILL

E.O. 12958: N/A
TAGS: ECON EFIN EINV ETRD BR
SUBJECT: BRAZILIAN CENTRAL BANK TAKES PRECAUTIONS FOR BANKS

REFS: A. Sao Paulo 0486; B. Sao Paulo 0522; C. Brasilia 1299; D. Sao Paulo 0086

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Brazil's banking system is well positioned to weather the external financial crisis. Brazilian bank assets are of good quality and the banks themselves, especially the larger institutions, have high levels of liquidity. Because of capital adequacy requirements, Brazilian banks are not as highly leveraged (only six to seven times), have reserves that outpace their respective Basel ratios, and lack derivatives and other financial instruments commonly found in the U.S. Economic interlocutors agreed that although the Brazilian system has enough liquidity without external credit lines, it is not balanced across the system. Small and medium banks are less liquid because they were more reliant on external credit lines and have a smaller deposit base upon which to draw. In response, the Central Bank (BCB) has taken several measures in recent weeks to redistribute liquidity across the system. The BCB's conservative behavior, including the stockpile of more than USD 205 billion in foreign reserves and high reserve requirements for banks appears to be a sound strategy to protect Brazil's banking system. Likewise, the Brazilian banking sector appears ready to defend itself. Although the impact and potential for bank failures is small, both the banks and Brazilian authorities are unwilling to take that chance and are moving proactively to keep the banking system healthy. End Summary.

¶2. (U) While Brazilians spent the last year of the worldwide financial crisis preaching the strength of the Brazilian economy, economists and government officials alike have slowly altered their rhetoric and actions given events over the last several weeks. Following the collapse of Lehman Brothers in September, Brazilian authorities from the Central Bank (BCB) and central government have undertaken several important precautionary measures to rebalance the liquidity within the Brazilian financial system to protect its integrity. (Note: See Refs A, B, and C for more on Brazil and the U.S. financial crisis. End Note.) In line with its conservative approach to regulating Brazil's financial system, the BCB intervened in foreign exchange markets in October, postponed planned increases to reserve requirements on leasing operations (Refs C and D), partially lifted the reserve requirement for large banks on time deposits, used foreign reserves to provide foreign currency for

exporters, and is also planning relief for agriculture finance.

¶3. (SBU) The BCB's actions represent an attempt to rebalance liquidity between small and large banks. The Brazilian banking system is solvent and has plenty of liquidity within the system. However, banking interlocutors told Econoff that large banks generally hold most of the available liquidity while small banks rely heavily on external financing. On October 2, the BCB eased reserve requirements on time deposits, essentially allowing large Brazilian banks to use up to 40 percent of their reserve requirement for time deposits (invested in GOB bonds) to purchase assets from smaller banks (defined as banks with capital up to R$ 2.5 billion). (Note: this is approximately 11 percent of the banking system based on net worth. End Note.) Joaquim Eloi Cirne de Toledo, a director at Nossa Caixa, told Econoff that this measure of allowing large banks to purchase assets from small banks was a welcome solution to redistributing up to R$ 22 billion (approximately USD $10 billion as of publication of this cable) within the Brazilian banking system. Similarly, the BCB has used dollar auctions to help alleviate the shortage of export credit lines. Chief Economist at the Federation of Banks Rubens Sardenberg defined all of these measures as a means for the BCB and GOB by extension, to gain time until the external scenario improved (or at least stabilized). He did not believe that the BCB would intervene and purchase small bank assets at this point, but instead would wait to evaluate whether the large banks' actions were sufficient.

¶4. (SBU) The GOB has strongly supported the BCB's moves to limit Brazil's exposure to the external financial crisis. The GOB has urged quick approval of the provisional measures that will authorize these regulations, as well as one that permits the BCB to directly

intervene to purchase bank assets as the lender of last resort, if necessary. President Lula has openly supported the BCB's actions and has pushed the Brazilian legislature to approve the measures. Thalis Murrieta, advisor to Senator Jose Tenario (PSDB - opposition party member and alternate on the Senate Economic Affairs Committee) told Brasilia Econoff that the measures proposed by the GOB enjoy broad support in Congress, though the opposition parties were sure to use the crisis to their political advantage. Murrieta also noted that the BCB needed the power to intervene not because of problems with the small banks themselves, but due to potential for crises of confidence. He asserted that in fact, the books of the small banks were quite healthy, but that giving the Central Bank this power would have a stabilizing influence.

¶5. (SBU) On October 9, the GOB granted the BCB the permission to intervene in banks in need of assistance. The BCB will have the authority to demand the sale of assets, block new business initiatives, and freeze the salaries of executives. Several contacts have told Econoff that large banks were already uncomfortable with small banks going under and the BCB's measures have created financial incentives for large banks to intervene. According to Alexandre Schwartsman, Chief Economist at Santander, large banks typically hold reserves above their requirement, so they are more likely to take the opportunity to use these reserves to purchase smaller bank assets. Similarly, Gilberto Meiches, Vice President of small Brazilian bank Banco Sofisa, told Econoff that his bank was open to the opportunity to sell some of its credit portfolio and that many other small banks would agree.

COMMENT

¶6. (SBU) Comment: Brazil's position in withstanding external financial instability is a result of prudence and good luck. The BCB has consistently faced criticism that its conservative policies have restricted economic growth; however, those policies have resulted in a strong and very cash heavy banking system. Brazil is fortunate because the global credit crunch has hit at a time when Brazil's credit cycle is just beginning to grow. Given the external scenario, the BCB is less likely to continue raising the benchmark interest rate, with some interlocutors suggesting the BCB would begin halting further increases as early as the end of October. The GOB's support has been a key to the BCB's ability to get the job

done, but it has been the BCB's conservative stance on regulatory and monetary policies that has paid dividends. True to its nature, the BCB probably will wait for its measures to take effect before jumping in as the lender of last resort. End Comment.

¶7. (U) This cable was coordinated/cleared by Embassy Brasilia.

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